



**ASIC**

Australian Securities & Investments Commission

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# Keynote speech: A new era for conduct regulation in Australia

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## ***CHECK AGAINST DELIVERY***

### **Introduction**

Good morning everyone.

I have had the pleasure of speaking at the Thomson Reuters Hong Kong Regulatory Summit in recent years and am delighted to be here participating in the Australian event.

As many of you may know, I started as ASIC's Chair a little over two months ago. My remarks today will focus on my views on the philosophy and practice of regulation generally and also explore the role of regulation in finance. In doing so, I will touch on what this might mean for ASIC's future direction.

However, I don't want the session title, 'A new era for conduct regulation in Australia', to mislead you: while I am relatively new, ASIC is not. And neither is the regulatory system it administers.

ASIC is filled with talented, strategically-minded and hard-working men and women who are in many ways the best in class at what they do.

So, my plan is to strengthen and build on ASIC's approach, and my remarks today should give you a sense of my regulatory philosophy in trying to achieve that.

## The regulatory system

To start, it is useful to step back from financial regulation, and look at regulatory systems more generally – that is, regardless of the relevant sector or industry.

In any sector, its regulatory system comprises more than the various regulatory agencies charged with developing, supervising and enforcing the rules. Regulatory systems also include, and require active participation from, the regulated population – people and firms – within that sector. And any discussion about the role of regulation must include recognition of the role that these participants play.

As regards finance in particular, our regulatory system was not designed as a police state, and this was deliberate. Instead, our system was designed on the premise that participants should do their part to ensure the system operates appropriately. One example of this is breach reporting. At its core this requirement relies on participants identifying breaches quickly and reporting them quickly.

This is why you may have heard me speak recently about the need for greater ‘professionalism’ in the finance industry. This is because, in part, professionalism is a good description of the role that is expected of participants in both the financial system and its governing regulatory architecture.

Of course, the regulatory system has, at its heart, regulatory agencies (and I plan to explore in detail their role in a minute). But before doing so we need to be reminded that no regulatory agency can be omnipresent – nor would you want us to be, as that would mean our regulatory system has become a police state. Again, this is why market participants need to play their part in the financial regulatory system in working toward the collective goal of efficient and fair financial markets.

We must also recognise that the regulatory system is not just supported by formal rules, but also by norms, industry practices and, of equal importance, community expectations. And this is why everyone in finance should not just ask if something is legally permissible, but also whether it is the ‘right thing to do’.

## What is regulation?

Before we turn to examining what and how ASIC regulates, we need to understand the definition of regulation. So what is regulation?

In my mind there are two definitions that are relevant to a financial markets conduct regulator.

The first is an economic definition. I use one offered by the OECD – that is:

Regulation is broadly defined as imposition of rules by government, backed by the use of penalties that are intended specifically to modify the economic behaviour of individuals and firms in the private sector.<sup>1</sup>

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<sup>1</sup> OECD, [Glossary of statistical terms](#).

The second definition of regulation relates to behavioural, or conduct, aspects. Here I like the definition proffered by Professor Christopher Hodges at Oxford University. Professor Hodges has done a lot of work on ethical business practices and ethical business regulation. In other words, he offers a guide for how industry participants and regulators participate in both the relevant economic sector and its governing regulatory system. Professor Hodges suggests that regulation is:

The sustained and focused attempt ... to alter behaviour thought to be of value to the community in accordance with achieving behaviour that corresponds to defined standards.<sup>2</sup>

Taken together, these definitions of regulation can be broken into three separate elements:

- First, there are behaviours that impact on an enterprise that is fundamentally thought to be of value to a community. This underlying enterprise (in our case, finance) is to be encouraged as it contributes to economic and/or social welfare.
- Second, there are standards for the performance of the worthwhile enterprise. These standards may be set by the state, but they are also supplemented by industry norms and community expectations.
- Third, the use of regulatory tools and coercive powers to ‘back’ those standards. Nevertheless, the primary aim of these regulatory tools is to change behaviour, rather than to just punish or censure.

So, put simply, regulation’s purpose is to modify behaviour, with respect to agreed norms, in order to preserve the benefits of the underlying enterprise (in our case, finance).

A very important aspect of this behaviour modification role is the identification of and management of harms. Here my language is deliberate since, ultimately, a regulator should be focused on harm prevention. Accordingly, in a regulatory context, I prefer the word ‘harm’ to ‘risk’.

It is unfeasible for regulators to totally eradicate harms. Nevertheless, regulation is a means to reduce them by finding ways to disrupt, or sabotage, harmful behaviour.

## Regulation of finance

The description of regulation I have just given you could apply to any regulated sector. Whether it be aviation, pharmaceuticals or food safety, the regulatory task is the same.

I want to turn now to finance and how this description of regulation applies to our sector. For a start, I want to be clear that when I speak of harm prevention I am not talking about eliminating risk from financial markets. Of course, risk is a key component of a functioning market system. Rather, I am talking about harms that prevent the worthwhile enterprise of finance from properly serving its role in society or result in human suffering.

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<sup>2</sup> C Hodges, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics*.

And what is that role? What is that ‘underlying enterprise’ that I just mentioned that is so valuable to society?

To answer this, we need to start by recognising that every cent in the financial system is ‘other people’s money’.

In other words, finance exists to serve everyday Australians. It is a means to an end, not an end in itself. And the consequence of this is that finance – and our approach to regulation – must be anchored to the core functions finance serves for society.

When it comes to describing these functions, I like to use Professor John Kay’s description, from his book *Other people’s money*, to guide my thinking. Professor Kay’s four functions are:

- first, capital allocation – matching those who need capital with those with excess capital
- second, inter and intra generational transfers of wealth
- third, hedging and insuring against risks, and
- finally, the payment system.

And so the goal of financial regulation is to maximise the fair and efficient operation of these functions for all Australians.

Against this background, I think it is useful to ask: why is finance so heavily regulated? There aren’t many sectors that have as many regulations, or regulators, as we have in finance.

I think there are basically four reasons:

- First, as I outlined earlier, finance serves a very important underlying purpose for society. Finance is a vital component of real people’s lives and we have seen from the financial crisis, and through the various conduct failures, that it can have catastrophic consequences for real people. It can cause real human suffering.
- Second, unlike other industries, the underlying ‘commodity’ or ‘product’ in finance is, essentially, money. For those in finance, the readily accessible nature of money creates the risk of being ‘blinded’ by the money, and thus losing sight of the underlying purpose of finance.
- Third, from a consumer perspective, the nature and complexity of finance is unlike any other sector. Moreover, the ‘democratisation’ of finance now means that most adult Australians need to make even more financial decisions than previous generations. All of this in a sector where products and services are:
  - intangible and often complex
  - purchased infrequently and, in the case of superannuation, may only be purchased as a result of compulsion, and
  - can represent extreme examples of ‘credence goods’, where the performance and quality of the good is in many cases not apparent for a long time after purchase.

- The fourth reason is that the regulatory system in finance, globally, has not been performing ‘at full capacity’ for quite some time. And what I mean by this is that the financial participants themselves have not played their part. There have been repeated instances of industry failures that have led to crises that have not been remediated by the industry, leaving additional regulation as the only response. Sure, financial regulators need to step up, but I genuinely think there are numerous examples of the industry ‘vacating the field’, meaning the regulators were the only ones left to act.

## ASIC’s regulatory approach – regulatory craft

Next I want to turn to what I think all of this means for ASIC’s approach and role.

Too often, discussion of ASIC’s role starts with the premise that all we do is enforce regulations using enforcement tools and coercive powers. This isn’t true and it never has been. ASIC does much more than just enforce the law.

To draw from another academic who has been a great influence – Harvard’s Professor Malcolm Sparrow – regulators like ASIC differ from most other public agencies since we ‘deliver obligations’, rather than services, for the purpose of modifying behaviours. And ASIC has a broad range of tools it can deploy to modify behaviour. These can be categorised into reactive tools and preventative or proactive ones.

The main reactive tools, to punish previous behaviour and deter future recurrence, are enforcement-based. However, there are also preventative and proactive approaches that can be deployed in order to modify behaviour prospectively. The proposed product intervention power for ASIC is a good example of such a preventive, proactive tool.

Drilling down a bit deeper, the range of preventative and proactive tools ASIC currently has include:

- gatekeeping – granting or revoking licenses or authorisations that grant permission to conduct business
- providing regulatory guidance or making formal rules
- conducting reviews and issuing reports to understand and highlight harmful industry practices
- engaging with industry to drive behavioural change
- financial capability and literacy initiatives
- providing policy advice to Government where the legislative framework needs to change or be updated
- influencing international policy and standard setting
- coordinating with other regulators domestically and internationally.

And the list goes on. I raise all this because, while enforcement is incredibly important, these other tools are of equal importance.

Ultimately, I subscribe to the view championed by Professor Sparrow that regulation is a craft. Professor Sparrow expresses this by saying:

... the essence of crafts lies in picking the right tool for the job, knowing when to use them in combination, and having a system for reorganising when the tools are inadequate so that new ones can be invented.<sup>3</sup>

This means using different tools in different circumstances, and recognising that one tool only – whether it is enforcement or surveillance – is not always the right solution for a problem.

In fact, for most of the problems in ASIC's remit, the solution will involve a number of tools. And while enforcement may be one piece of that solution, there may also be a number of other tools used for the same problem. To use the 'craft' analogy, there is no point in hammering away when what you really need is a wrench.

We have to recognise that reactive tools, like enforcement-based tools, by definition involve intervening after the harm is done. Actually, the more difficult challenge is for a regulator is to intervene before the harm manifests itself.

It's also important for all of us to recognise that there are also a number of operational and strategic dilemmas that arise when considering the use of enforcement tools:

- First, enforcement is intrusive, adversarial and expensive – expensive to the industry and taxpayers who fund these actions.
- Second, like every other regulatory agency on earth, we cannot punish every breach.
- Third, there are external constraints and variables for enforcement action – for example, court processes can take a long time, particularly for criminal matters. To this end, and paradoxically, in ASIC's experience securing compensation for consumers is usually more efficiently obtained without going to court.

Now, just because I have spoken openly about these enforcement dilemmas it should not – I repeat, not – be taken as a signal that we will be reticent about using our enforcement tools. Nothing could be further from the truth. I am certainly not suggesting that ASIC will be any less of an enforcement agency going forward.

What I am saying is that when we discuss our regulatory system we need to broaden this discourse beyond just the deployment of enforcement tools. We need to actively consider and assess all the regulatory tools available, always keeping in mind that ASIC is in the 'business of modifying behaviours'.

Ultimately, we all must recognise that we have a very sophisticated regulatory system. And I am not just talking about the twin peaks structure. I am talking about the role of market participants in ensuring the integrity of the broader financial system.

I think the line used so effectively by General David Morrison – that 'the standard you walk past is the standard you accept' – applies equally to behaviours we expect of the custodians of other people's money.

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<sup>3</sup> M Sparrow, *The Regulatory Craft*, Brookings Institute Press, 2000.

And I am also talking about the role of regulatory agencies who need to identify, diagnose, prioritise and then address the harms and behaviours that endanger trust and integrity in our financial markets.

This is first a strategic task, and then a tactical one. And this strategic and tactical approach is what we are further embracing at ASIC.

## Conclusion

In closing, I am grateful to Thomson Reuters for giving me the opportunity to speak today. Fora like this one are important for contributing to a more sophisticated understanding of our regulatory system, as well as for discussion and debate of current regulatory issues.

And I will end with my favourite quote in the field of regulatory strategy that also comes from Malcolm Sparrow. It was originally intended for regulatory agencies, but I think equally applies to industry participants who form such a vital part of the regulatory system: 'Pick important problems and fix them!'

So let's get on with it!